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PENSION REFORM IN UKRAINE

By Denise Lamaute, Senior Pension Reform Advisor
USAID/W ENI/PER

INTRODUCTION

The purpose of this report is to assess[1] the status and prospects of pension reform in Ukraine. This report also seeks to analyze the extent and value of the pension reform technical assistance that has been provided to the Government of Ukraine (GOU) by international donors, in general, and the U. S. Agency for International Development (USAID), in particular. One of the main conclusions sought from this analysis is whether there is merit in USAID continuing to provide pension reform technical assistance to Ukraine, and if so, in what manner.

USAID, along with other international donors, - The World Bank, the European Union, the International Labor Organization (ILO), United Nations Development Programme (UNDP), and various countries - has provided pension reform technical support to the GOU since about 1994. Such assistance has been provided to support Ukraine's economic development as well as to help strengthen its social protection safety net in a manner that is fiscally responsible.

Ukraine, like most of the former communist countries, inherited a national pension system in the early '90's that promised a wide range of social protection benefits without regard to the financial impact on the national budget. In most instances, such broad promises were financially untenable because the pension systems were bankrupt or quickly became bankrupt. Contributions collected were far too little compared to the benefits that were being paid or promised. Ukraine was no exception in this regard with a pension deficit of $39 million in 1995, about $600 million in 1996 and 1997 and $576 million in 1998 (1.9% of GDP).

The pension deficit in Ukraine has continued to grow even after the benefit amount per retiree has been reduced significantly. The minimum pension in 1990 was about $60 per month. Today, retirees receive less than $20 per month as a pension benefit, less than the poverty level amount of $30 per month.

Numerous other pension challenges exist in Ukraine. Here again, however, the challenges that Ukraine faces mirror those of many of the countries in the ENI region. For example, demographics impose a major challenge to the pension system. The projections indicate that there will be far fewer workers in paying into the national pension system, compared to the number of anticipated workers beginning in 10 years, the baby boomer phenomenon. The informal economy, which is often mentioned to be as high as 40% to 50% of Ukraine's economy, significantly reduces the level of pension contributions that the pension system should receive. Enforcement and compliance are poor, which is certainly one reason why so many evade the system. Moreover, the policy choices regarding benefits, retirement age, contributions and years of service have not been well thought-out, analyzed or curtailed sufficiently to bring stability and predictability to the pension system. In light of these dynamics, it still begs the question whether the technical assistance that USAID has provided to Ukraine has made a meaningful contribution in improving the pension system in Ukraine. Is pension reform important to Ukraine? If so, what are they doing to alleviate

[1] This assessment is based on information received from numerous reports and interviews of international donors, pension experts, and GOU officials. The conclusions reached are those of the author.

poverty for their retirees? What steps are they taking to reform the current pension system to put it on a fiscally sound basis, while at the same time providing an adequate income for their retirees? Are there any champions, individuals or groups, which are pushing the pension reform agenda? And, more importantly for the USG, should USAID continue to provide pension reform technical assistance to Ukraine?

USAID's Pension Reform Activities in Ukraine

USAID has provided pension reform technical assistance to Ukraine since 1995, albeit on a very limited basis at that time. In 1995, in response to a request to then U. S. Ambassador Miller from the chairman of the Rada Labor Committee for assistance in the area of private pension funds and other social safety net issues, a study tour was organized for several GOU officials. This study tour to the U.S. in the late summer of 1995 focused on educating mid-level Ukrainian officials involved in pension issues on pension management, regulation, and operations. A conference on pensions was also held in April of that year wherein the World Bank and the International Labor Organization (ILO) participated.

In 1996, USAID entered into a Cooperative Agreement with the Harvard Institute for International Development (HIID) to introduce macroeconomic policy-making tools to the GOU. This project, which continues today, has attempted to assist the GOU in using such tools to improve its macroeconomic situation in the areas of monetary policy and tax and budget system reform.

- HIID's project has included assisting the GOU in 1996 develop a comprehensive economic reform program which included pension reform analysis. This reform program was submitted by the Vice-Prime Minister's Office for Economic Reform to the Parliament for adoption. The Parliament, however, rejected this economic reform package. Notwithstanding the rejection of this economic reform package, some view the introduction of this economic reform package as the catalyst that has prompted some in Parliament and in the President's office to begin thinking about reforming Ukraine's pension system.

- Since 1997, HIID has worked on macroeconomic capacity building with the GOU by educating it on using macroeconomic quantitative analysis in reshaping Ukraine's economic picture. HIID has provided seminars, discussions, and prepared and distributed literature on the subject to the Ministry of Economics, the Ministry of Finance, the Prime Minister's Cabinet of Ministers, the President's Administration, the National Bank, Parliament, the Ministry of Labor and Social Policy (MOLSP), the National Pension Insurance Fund (PIF) and the Institute of Economic Reform, one of the key think tanks in Ukraine.

PADCO, a USAID contractor, has been providing social protection technical assistance in Ukraine since 1995. One aspect of their current project (February '98 –January '00), about 1/3 of their contract, deals with pension reform. In this regard, PADCO has helped the GOU develop administrative and analytical tools in the pension area.

Specifically, PADCO has been successful in the following pension reform areas:

- Developing a recordkeeping system of employee wages and contributions. Prior to this effort, Ukraine did not have a database of employee information such as wages per employee, contributions, or retiree benefits paid. This effort, albeit in an embryonic stage, will eventually allow the GOU to not only collect relevant employee and employer pension information, but will also give it the data needed to analyze the pension system and make reasonable projections.

- Working to restructure the national pension system so that most aspects of pension management and administration rest with one agency and not three agencies, as it currently does. This effort should make the national pension system more efficient and ultimately more cost-effective.

- Establishing an Office of the Actuary to provide pension analysis and advice on pension policy issues. Prior to this effort, no such entity existed. The GOU did not use analytical tools and methodologies to make pension policies or budget impact assessments. Thus, pension decisions have been chaotic, financially unfeasible and unreliable. The Office of the Actuary will be designed to bring integrity, predictability and reliability to the pension policymaking process.

- PADCO is developing two pension actuarial models, an Excel model and the PROST model suggested by the World Bank, to provide an analytical framework to assess the current and future pension programs. One or both of these models will be used by the Parliament, the Office of the Actuary, when it is fully established, and the Ministries of Labor and Social Policy and Finance as one of the analytical tools needed when developing social programs and budgets.

USAID's technical assistance has helped the GOU begin to frame the issues regarding pension reform. When helping a country such as Ukraine put economic, financial and social infrastructures in place, which pension reform requires, we must expect the development process to be slow and arduous. Thus, it is imperative that we recognize that USAID has been successful in helping Ukraine improve its economically and socially declining situation. It is also imperative to recognize that this success has happened in an environment that was totally unfamiliar with the inner workings of a market-driven society. The thinking, culture and behavior from a different time and different economic direction have to be overcome before USAID can be reasonably assured that the reformed systems that it is supporting will have integrity and longevity. Such a challenge demands a long-term commitment from those that seek real progress.

Assess and Indicate the Commitment of the Government of Ukraine and Various Political Groups to Pension Reform - What is the Likelihood of a Commitment to Pension Reform after the Presidential Election this October, 1999

From all accounts, Ukraine does not have a champion of pension reform. No one person, political party, organization or institution seems to be truly committed, vocal and planning to reform the pension system in Ukraine. Most often, it was opined, the people and policy makers "talk" about making changes to the pension system, but political will or energy is **not apparent** in Ukraine at this time. Moreover, such a champion is not likely to materialize soon, regardless of the outcome of the presidential election this October.

There is a tiny segment within the government, the presidential portion of the GOU, and an even smaller group in the Parliament that appear to be pension reform minded. The Minister of Labor and Social Policy, Mr. Ivan Sakhan, along with his Deputy Minister, Ms. Olena Haryacha, can be seen as pension reform thinkers within the government. Others who can also be viewed as a pension reform thinker are Mr. Valerij Sushkevych, a Member of Parliament and the Chairman of the Parliamentary Committee on Pensioners, Invalids and Veterans Affairs, Mr. Victor Pynzenyk, former Vice-Prime Minister for Economic Affairs, and Mr. Vladimir M. Matvijchuk, Deputy Minister of Finance. However, these known reform minded thinkers expressed their grave concerns about not being sufficiently knowledgeable about pensions. Perhaps it is the lack of in-depth pension knowledge within the country why there are so few pension reformers in the government or the Parliament. The majority of the decision-makers may just not know why the pension system needs reforming, how to reform it and when to reform it. The knowledge that it is not a good system is pervasive. But the road map to improving it is not so obvious.

The GOU, however, has taken a few steps toward pension reform. Those steps are:

- Discussions among policymakers about pension reform are more frequent. For example, at a recent roundtable meeting of government officials, parliament members, trade union representatives, and international pension experts, a discussion of various aspects of a fully funded pension scheme, known as the 2nd pillar, took place. Such discussions help to move the pension reform agenda forward, albeit the success of such discussions can not be measured.

- $20 million is being spent by the GOU to improve the pension information management system.

- The GOU has agreed, by decree, to establish the Office of the Actuary.

- The pension system is being restructured to be more responsive, as well as effective and efficient.

- Committees within the government and Parliament are being established to develop pension policies.

Indicate the Major Issues Surrounding Pension Reform and the Likelihood of Their Being Resolved.

The major challenges facing the pension system in Ukraine are:

- Low benefits
- Widespread contribution evasion
- Large number of retirees
- Inefficient administration
- An unpredictable and unreliable system
- A financially unsound and unsustainable system
- Large pension arrears
- Benefits paid without regard to work history
- Lack of confidence in financial institutions

<u>Low Benefits</u>

Ukraine does not provide an adequate income for its retirees. Based on its current retirement program, future retirees will be even worse off. The pension benefits paid today are below the poverty level for Ukraine. Ukraine's poverty level is about $30 per month while its pension benefit is about $20 per month. The average wage in 1998 was $56 per month.

According to the IMF, the replacement rate, the average pension retirement income as a percentage of the average wage, has decreased. The replacement ratio declined from 43% in 1993 to 30% in 1996. Today, the replacement ratio is about 35% after the inflation and low-income adjustments. In comparison, the target replacement ratio in many countries is often between 60% and 70%. What this trend suggests for Ukraine is ever-increasing poverty for retirees if what retirees receive as a pension is a lower replacement rate, downward real wages for workers and increased inflation for consumers.

Widespread Contribution Evasion

Ukraine is said to have an informal economy of as much as 40% or 50% of the formal economy. The presence of a substantial portion of the economic resources escaping the legal structure of Ukraine greatly reduces the amount of pension contributions that the GOU collects. According to a Member of Parliament, about 50% of the money in Ukraine is circulated outside of its banking system.

Such massive income evasion is indicated to be due to widespread under-reporting of income or the deliberate disregard of reporting income at all. Clearly, income evasion works to undermine the financial stability of the pension system as well as the overall economy.

Large Number of Retirees

Ukraine has 14 million pensioners and the number of workers contributing to the pension system just about equals that. As in all Pay-As-You-Go (PAYG) pension systems, the pension system is heavily dependent on paying retirees based on the amount of contributions received from current workers. The more workers to the number of pensioners, the more financially sound a PAYG system will be. Conversely, too few workers can not support a PAYG unless benefits are reduced drastically and payroll contributions are increased dramatically.

Ukraine has and will continue to have an imbalance of retirees to workers for several reasons. The fertility rate in 1959, during the baby boom period, was 2.3%. With a declining fertility rate of 1.9% in 1966 and 1.3% in 1997, the generation of workers that should support the baby boom generation when it retires will be decidedly smaller.

Apart from birth rates, Ukraine's population, particularly the working age population, has decreased due to migration. Since 1995, workers have left Ukraine for other countries where the average wage is higher than in Ukraine, such as Western Europe, the U.S., Canada and Israel. The population declined by 94,500 in 1995 and over 120,000 in 1996 due to emigration as an important factor.

The retirement age of 60 for men and 55 for women is deemed to be low by international standards. The right to early retirement or a retirement disability pension is available to too many workers, even when many are able-bodied. Also, about 12% of pensioners work, and some of those pensioners continue to work, producing an income that should in effect remove them from the pension rolls until such time that their wage income has been reduced or eliminated. These factors which encourage a large number of retirees, particularly in light of the decreasing work force, are a heavy burden on the PAYG system.

Inefficient Administration

Ukraine's pension system is woefully inefficient and costly. The GOU uses three entities to manage its pension system. The Ministry of Labor and Social Policy’s Office establishes the benefit payment amounts. The National Pension Insurance Fund (PIF) collects the contributions. The Ministry of Communication is responsible for making the pension benefit payments through its local post offices.

The pension system is not considered a national pension system in the truest sense of the word. Pension activity is largely handled at the local level without providing information or data of this local activity to the National Pension System or the MOLSP. In other words, the GOU has little or no reliable data about what it receives in contributions, pays out or who its employee participants or retirees are.

The GOU does a poor job of enforcement and compliance of the pension system. Too many entities do not pay contributions in full or in a timely manner. According to the IMF, the nonpayment of contributions equaled 1.7% of GDP in 1995, roughly $350 million. In 1998, contribution arrears approached $1 billion, about 3.4% of GDP.

An Unpredictable and Unreliable System

At various times, without the benefit of a cost-benefit analysis or the facility to deliver, the Parliament or the President's Office has declared an increase in pension benefits. For example, in December 1997 the Parliament raised pension benefits; however, these raises have all but been ignored, not paid, because of the financial untenability of such promises.

Different groups of pensioners, miners, military, child bearing or rearing mothers, etc., may receive a little more in pension benefits than others on what appears to be an arbitrary basis.

Some pensioners are not paid in cash but are instead paid in-kind with a voucher equal to their pension benefit amount. This voucher can only be taken to the Pension Insurance Fund "store" to be exchanged for other in-kind goods that the PIF received as contribution payments. The in-kind value of the goods is often overvalued, thereby reducing the real value of the pensioners' vouchers.

Because the pension system operates on a regional basis and not a national basis, pension arrears are a function of how economically well off a region is. Pensioners in richer regions, such as those in Kiev or other urban areas, tend to get paid more regularly and in full. Of course, poorer economically developed regions, such as Zakapartia, which is adjacent to Romania, are in arrears in pension payments by as much as 6 months in the last two years.

For example, in one region, the August 1998 pensions were just paid this month, February 1999.

The above are just a few examples of the unpredictability and unreliability of the pension system. Much of the discussion has focused on the benefits side of the equation. The contribution collection side of the equation, as indicated above, is equally unpredictable and unreliable.

A Financially Unsound and Unsustainable System

Despite allocating a share of GDP to pensions that is comparable to Central and Western Europe (10%), Ukraine provides pension benefits that are barely 60% of its very modest poverty level ($30 per month). The amount of pension expenditures has increased steadily from 7.9% of GDP in 1995 to 10% in 1997. In contrast, the amount of pension benefits has deceased from $60 per month in 1990 to $20 per month today.

The pension deficit has also grown. It was .1% of GDP in 1995; 1.4%% of GDP in 1996 and 1997 and 1.9% of GDP in 1998. Pension benefit arrears for 1998 were over $500 million.

The evasion issue mentioned above is just one factor that contributes to Ukraine's problem of maintaining a reliable contribution base. Also contributing to this problem is the bartering system, wherein contributions are paid not in cash but in-kind and cannot be converted to cash. Added to this factor is the tendency of employers to reduce the amounts subject to pension contribution assessment by reclassifying compensation into categories that are exempt from payroll tax such as free flats, fuel, and income paid in-kind.

The pension system is unable to collect sufficient revenues to meet its obligations. And, moreover, even if it did, the actual pension benefits are inadequate in a climate where the payroll tax on employers are deemed too high, one of the highest in the world. Employer contributions equal 32% of gross payroll. Such high payroll taxes will contribute to making Ukraine uncompetitive in a global competitive market place.

Projections from the World Bank indicate that even more retirees will have to be serviced by Ukraine's bankrupt pension system, which has no prospects for solvency anytime soon. The forecasts for the population over age 60 are that this age group will continue to increase, rising from 18.7% of the population in 1990 to 21.3% in the year 2000; 24.5% in 2020 and 25.5% in 2030. Where will the money come from to support these retirees, particularly in light of the fact, as indicated above, the working population is shrinking?

Large Pension Arrears

According to the IMF, the pension fund arrears have increased steadily since 1995. In 1995, the pension fund arrears were 1% of GDP and 1.4% in 1996 and 1997. At the end of 1998, Ukraine had about $576 million in pension accumulated arrears, 1.9% of GDP.

A current IMF package includes a provision that the GOU decrease the pension arrears. With the Presidential election this year, it is remotely likely that some of the pensioners will receive some of the arrears due them. If not, this issue will most likely be used by the opposition as a reason to defeat the current President.

Benefits Paid Without Regard to Work History

Generally, workers can rely on receiving their paltry pension benefit without regard to what their earnings record reveals (if such records were actually available) or how long they actually worked. It seems as if Ukraine basically pays everyone a pension when they get ready to collect a pension. Pension benefits are not tied to the amount or wages one has earned over his or her working career. Instead, the last 2 years or some other set of years can be considered, if the retiree so desires this method of calculating pension benefits. Moreover, the years of service used to determine a full pension takes into account years unrelated to whether a person actually worked or not. For example, full-time students get years of service credits, mothers with children under a certain age are given pension years of service credits, military personnel get years of service credits, etc. etc.

The pension system is also responsible for handling benefits that are not work-related. For example, a benefit for child-related matters is deemed a pension benefit handled by the PIF. These benefits, the non-pension benefits, should be deemed social benefits and handled by some other agency. Moreover, the pension contribution tax on employers should not be used for these non-pension benefits to help reduce the heavy payroll tax burden on enterprises.

Lack of Confidence in Financial Institutions

It is believed that while many talk about the prospect of introducing private pension

schemes, a mandatory one appears to be most frightening to many. It seems as if the public has little or no confidence in Ukrainian financial institutions for several reasons. One, galloping inflation, as much as 1000% in 1991-1993, wiped out the value of everyone's savings that were in financial institutions at that time. Pyramid schemes from 1993 through 1996 took another chunk of savings, and the government is believed to have done little about condemning or prosecuting those responsible for this illegal activity. Three, the people have little or no confidence in the GOU's commitment to repay its bond debts. Four, the capital market is practically non-existent, shallow and illiquid.
Five, banks and investment firms are generally believed to be unreliable and poorly regulated.

According to one of the Commissioners of the Securities Exchange Commission, companies are currently offering private pension funds or investment funds that are not regulated. If these funds produce a scandal like the pyramid scandals, the public's trust in the financial institutions will be further eroded. The prospects for legal and regulated private pension funds will be made all the more difficult to support.

These factors seem to encourage the left portion of the Parliament, often referred to as the far left or extreme Communists, to support and encourage maintaining the solidarity system. It is this group that is most vocal against pension reform, in general, and a funded pension scheme, in particular.

Pension Resolution Prospects

Few of the challenges confronting the pension system in Ukraine will be solved soon. Neither the government nor the Parliament is proposing systemic structural changes to the pension system in Ukraine. While the government is viewed as slightly more reformist than the Parliament, there is no group, person, or entity that is championing pension reform today. Of course, the upcoming Presidential election is attributed as responsible for this lethargy. That means that the Parliament will not likely eliminate the early retirement or special privilege benefits. It will most likely not raise the retirement age this year or next. And, it is highly unlikely that it will address collecting any significant portion of the contribution arrears. It is important to note that many of the entities that owe money to the PIF have gone bankrupt or are wholly or partially owned by the government itself.

Clearly, one of the primary challenges to pension reform is improving Ukraine's economy. For the last seven years the economy has declined. Little or no economic growth is anticipated for Ukraine for the next two years. Thus, until the economy grows, coupled with strengthening pension administration and regulation and implementing sound pension reform measures, the pension system will continue to be fiscally unsound and unstable.

Bartering, in-kind activity, plays a large part in the Ukrainian economy, about 40% to 50% of GDP. It, however, negatively impacts the pension system. These payments are not captured and thus escape taxation, thereby reducing the revenues that the GOU should collect. Until the GOU eliminates this aspect of doing business, the pension revenues will continue to be unreliable and unpredictable.

What is unclear is the impact of the constitutional guaranteed rights to certain social protection measures, including pensions, on pension reform. These guarantees raise the issue of whether the constitution of Ukraine must first be amended before pension reform can be undertaken. Some contend that pension reform can proceed meaningfully within the constitutional guaranteed rights framework. Until this issue is examined carefully, the essence of the constitutional impact on pension reform is uncertain.

While there is tremendous pressure from the business sector to reduce payroll taxes, there is equal or more pressure from the trade unions and the general public, not just pensioners, to increase pension benefits. Nowhere in the discussion about pensions is there a program or strategy to reduce the large informal economy and concentrate on growing the overall economy. Thus, where will the money for pension reform come from? Where will the money for increased benefits, if they are increased, come from? No sector of the GOU, business or trade unions seems prepared to answer these tough questions; until such time that they do, pension reform is not imminent.

Indicate What Contributions Other International Donors Have Made and What Their Future Pension Reform Plans Are

The International Monetary Fund (IMF)

The IMF was not optimistic about the GOU undertaking any meaningful pension reform in the next year or two. It appears to be so pessimistic on this point, that it did not include pension reform as one of its conditions in its current EFF loan, although it firmly believes that the Ukrainian pension system with 14 million retirees is financially unsustainable. Instead, it will look to the World Bank for any systemic pension reform activity. It will, however, continue to push for a reduction of the amounts due to pensioners.

In 1997, the IMF did impose pension reform conditions in its EFF loan. It wanted the GOU to increase the normal retirement age from 60 for men and 55 for women by 1 year per year for the next five years, namely age 65 for men and age 60 for women. It wanted to eliminate the generous early retirement program for privileged workers such as miners, military personnel, and others. However, these conditions were rejected by the Parliament.

The IMF did express an opinion that it believed that the GOU would introduce private pension legislation, which it has, with two draft laws currently circulating within Parliament. Such private pension schemes, it hopes, would most likely not be instituted until after a private pension regulatory body had been established to combat the money schemes that have plagued many of the ENI countries.

The IMF was not optimistic about the prospects for private pension funds in Ukraine because of the nascent financial institutions and regulatory bodies. The capital markets, it opined, were not liquid, transparent or well regulated. At best, the stock market was too shallow. At its worst, it was highly suspect, at this time, as a place to put accumulated amounts of pension funds.

According to the IMF, the GOU would most likely not pursue pension reform in earnest until the pension situation became direr. It seems as if the GOU concentrates on the crisis issues of the day without much attention given to systemic changes to the economic framework.

Notwithstanding IMF's less than rosy outlook toward pension reform in Ukraine, it continues to provide macroeconomic technical assistance to the GOU. It provides macroeconomic training to about 20 to 30 different government officials annually. It has four outside experts currently based with the GOU dealing with statistics, banking re-structuring, and macroeconomic and fiscal issues. It also is providing short-term legal and tax experts to the GOU.

International Labor Organization (ILO)

In 1996, the ILO in participation with the United Nations Development Programme (UNDP) and the World Bank (WB) provided pension reform technical assistance to the GOU in the form of developing a computer model for social budgeting. This project, which was completed in early 1998, included 17 members from various ministries who were charged with helping develop this model to enable the GOU to prepare social sector budgets under three possible scenarios.

A presidential decree was issued last year mandating that social budgeting be implemented. The ILO is confident that their model will be used for this social budgeting effort.

The ILO since 1992 has organized study tours on social protection issues. These tours have included trips to several European countries and a visit to the Chilean Embassy in Kiev to learn about Chile's pension reform program.

In response last year to a request from the MOLSP, the ILO reviewed the GOU's draft pension reform law. The ILO's position on this draft law is that they support it in principle but are cautious on the idea of any 2nd pillar activity, a mandatory funded pension scheme. Their recommendation was that the GOU do more actuarial analysis before proceeding with the 2nd pillar idea. Also, they would prefer that such a scheme be introduced as a pilot program to emphasize their position that the GOU take this step toward pension reform slowly.

In the Memorandum of Understanding (MOU) between the ILO and the GOU signed October 1998, the ILO provided among its objectives additional pension reform technical assistance in the form of:

1. Review of pension reform draft laws;
2. Implementation of the social sector budget model;
3. Training and seminars about private pension fund activities including an assessment of the appropriateness of an individual pension accounts system in Ukraine; and
4. Training to the self-governing bodies dealing with the national pension scheme, the 1st pillar.

The European Union (EU)

The EU has two pension reform technical assistance projects running. One provides training for actuaries. The other is a small portion of a broader social protection project. It does not, however, have any concrete plans to provide pension reform technical assistance for the next two years.

The EU is in the process of committing 1 million Euro to a 12-month project to assist the GOU build capacity in managing family benefits and pensions. The focus will be on establishing policy advice units within the agencies that deal with these issues.

The EU would most likely not participate with other international donors in a joint effort to provide additional pension reform technical assistance to the GOU. According to the EU representative, there is no political will in Ukraine to reform the pension system. As such, the EU is not contemplating committing any more resources to this effort.

The World Bank (WB)

Pension reform in Ukraine is a very important issue to the World Bank. Nevertheless, the

WB is scaling back all its operations in Ukraine until after the Presidential election this year. After the election, the WB will assess if the government and Parliament are prepared to talk to each other, which according to the WB, they are not. They will have to cooperate more fully if reforms are to happen in Ukraine and the WB gets more actively involved in pension reform.

The WB stressed that pension reform technical assistance is definitely needed from the international donors. In fact, the WB believes that the international donors cannot drop pension reform from their various agendas, although there is very little that the international community can do about starting the pension reform movement. The WB suggested that the international donor community focus on institutional capacity-building and educating the people and the GOU about pensions and the need for pension reform, without concentrating on the issue of how many pension pillars Ukraine should have. Most pension and economic experts and GOU officials expressed this sentiment.

Last fall several GOU officials attended a WB-sponsored pension reform workshop in Vienna, Austria. In 1997, the WB invested in several pension reform missions to Ukraine, which resulted in the WB deciding not to suggest that a $200 million adjustment loan be provided to Ukraine. It seems as if the political will that the WB needed in order to recommend this loan was not present in Ukraine, namely support for a fully-funded pension scheme, increasing the retirement age, eliminating privilege benefits and other critical pension policy criteria.

The WB believes that about 70% of the elderly retirees would prefer to go back to the Communist pension system. At least it delivered a pension benefit greater than what they currently receive. On the other hand, workers age 40 to 50 tend to be more accepting of the idea of a funded pension system that will provide good results in 40 to 50 years.

The WB is planning a two-week pension reform assessment mission next month, March 1999.

<u>Germany</u>

Germany has provided pension reform technical assistance to the GOU since 1994. They have a macroeconomics project that is looking at budget issues. Within this project is a small commitment to pensions and pension reform in Ukraine. Another German project provides short-term pension experts who consult with the GOU on various pension issues.

One of the recommendations from the macroeconomic team is for Ukraine to introduce a 2nd pillar, but only after the PIF is restructured and has the capacity to manage its operations efficiently. It also included in this recommendation that the GOU pass coherent laws and regulations first, before instituting pension reform including a 2nd pillar. Additionally, it recommended that regulatory capacity should be developed before a 2nd pillar is introduced.

Once these pre-conditions are in place, and not before, the German macroeconomic team recommended that the 2nd pillar be managed by a foreign investment entity and that the assets, at a 1% contribution rate, be invested outside of Ukraine. This slow approach would allow Ukraine to work on other deficient areas while proceeding to address the pension crisis sooner, rather than waiting until "everything" was in place. Over time, it was suggested, the assets would be managed by Ukrainian financial institutions in the Ukrainian-developed capital markets.

Provide a Comparison of the Status of Pension Reform in Other ENI Countries Compared

to Ukraine

Shortly after communism fell in Central and Eastern Europe, most of the CEE countries had pension deficits. For example, Macedonia, Albania and Bulgaria had pension deficits that equaled about 6%, 3.5%, and 3% of GDP respectively in 1993, according to the World Bank. Many policy makers in the CEE countries in search of an answer to this untenable financial situation have concluded that private pension schemes coupled with a reformed public pension scheme could address the increasing dependency ratio (the number of workers to retirees) and the unsustainable budget demands that their public pension systems were causing. Many CEE countries are developing pension reform policies in this direction while others are further along with pension reform laws enacted and being implemented. In most respects, it is too early to say that pension reform is a huge success in any CEE country. It is safe to say, however, that pension reform is progressing well in many CEE countries, albeit, at varying rates depending on the country in question.

For example, Hungary has taken the lead in the CEE with pension reform. In 1993, it introduced a voluntary 3rd pillar private pension scheme with tax incentives. In 1997, it passed a pension reform law that reformed its 1st pillar public pension scheme and introduced a mandatory 2nd pillar private pension scheme. Contributions to the 2nd pillar began in January of this year with 1.2 million workers, one-third of the workforce, voluntarily joining the new pension system in just 6 months. New entrants to the workforce after July, 1998 are required to participate in the new system. Regulation of the 2nd pillar scheme to ensure that the workers' contributions are safe, secure and fully accounted for is the biggest challenge to Hungary's pension reform effort at this time.

The NIS countries have not embraced pension reform as readily as the CEE countries have. Only Kazakhstan has pushed ahead with a reformed pension system that was introduced this year. The other NIS countries appear to be in the early stages of pension reform, namely coming to grips with the need for pension reform and deciding what such a reform should look like.

Provide Recommendations to USAID About Whether to Continue to Provide Pension Reform Technical Assistance to Ukraine. Include an Assessment of the Implications if No Meaningful Pension Reform Effort Were Pursued by the GOU. Also Include an Assessment of the Resources USAID Should Consider Committing if It Were to Continue with A Pension Reform Program.

Ukraine needs to reform its current bankrupt, ineffective and inefficient pension system. The international donor community should continue pension reform technical assistance. USAID, in particular, should continue to support pension reform in Ukraine.

USAID's technical assistance should continue to stress educating policy makers and the public about why their pension system in its current form is financially untenable and wholly inadequate. More importantly, any educational or training programs, if provided, should stress 1.) Providing a public education campaign to educate the people, not just the policy makers, about the pension reform issues and 2.) Developing a broad base of pension knowledge that will enable the Ukrainians to establish (analytical and legal framework), regulate (oversight, enforcement and compliance), and manage (administration and operations) public and private pension schemes that will be reliable, predictable, efficient and effective. The objective of such pension reform technical assistance, in essence, should help the GOU build the institutional capacity that currently does not exist in Ukraine for a sound and safe pension system, be it public, private or a combination of public and private schemes.

It is critical that we appreciate the challenge that Ukraine faces as it moves from a planned economy, wherein the government did everything, to a market economy, wherein the government role in society should be limited. The time and energy need to re-engineer a society is a long one. Methods, approaches and understandings for a planned economy are not often compatible with market economies. Therefore, it is important to recognize and accept the difficulties that the GOU and the people of Ukraine are experiencing as they confront their lack of knowledge and understanding of many aspects of a market economy, which is a complex and demanding one. Consequently, we must be patient and cautious, which means making a long-term commitment to the economic and social protection reform programs that are needed in Ukraine.

With a long-term pension reform technical assistance commitment, it would be advisable that USAID help to prepare Ukraine to prepare for pension reform. Ukraine needs to develop a much better understanding of what pension planning, management and regulation consist of. It needs to take the time to study the issues before hastily adopting laws and regulations that are not well thought out, analyzed or remotely sufficient to achieve the short-term and long-term goals and objectives that the GOU needs.

My recommendation is that USAID devote the next two years to educating and training policy makers, legislators, and the public on broad pension issues related to public and private pensions. If the public and the policy makers are more informed about the pension issues, they will certainly be more equipped to deal with the tough fiscal and social issues that Ukraine faces. I would urge USAID to bring in a variety of pension experts, such as pension lawyers, trustees, regulators, record keepers, pension software experts and investment managers, to teach about the various aspects of pensions. The objective of this assistance would be to provide the tools that will assist the GOU develop a good pension reform law and the people of Ukraine to accept those new laws and the resulting programs.

I strongly recommend that USAID continue to support the development of an effective and efficient national pension database that will be capable of capturing all pertinent pension information related to employees, employers, contributions and benefits. In that vein, assisting the Pension Insurance Fund improve its administrative capacity would be of tremendous benefit to the GOU. Thus, if and when Ukraine implements a private pension system, it should have the regulatory capacity to ensure that participants' assets are safe and secure, and that the private system has integrity and predictability.

Assistance for regulating a voluntary private pension system may require sooner action, considering that there are over a dozen such funds currently in operation without the benefit of any law or regulatory body. A scandal in this area, similar to what occurred with the pyramid schemes, would further erode the confidence in the financial institutions in Ukraine.

Emphatically, USAID should discourage the development of a mandatory private pension system until it is apparent that such assets will be safe and secure, when the legal, regulatory and administrative institutions exist and operate well. Equally important to supporting a mandatory private pension scheme, is the existence of an efficient capital market, or at least a good indication that the capital market is on a solid foundation toward development.[2]

Assuming that a good pension foundation has been laid in the next two years, USAID

[2] I have not provided an opinion about the prospect of moving forward sooner with a mandatory private pension scheme managed and operated solely by non-Ukrainian investment firms with the mandate that the assets be invested in non-Ukrainian securities, the German macroeconomics team's suggestion. I did not have the time or sufficient information to analyze this alternative.

should anticipate another two to three years thereafter for developing and implementing a private pension system, if one is introduced. Of course, there may be some overlap of time, but USAID should estimate at least a 4 or 5 year commitment to pension reform in Ukraine if a multi-pillar pension system is pursued. It is a timing and sequencing issue, what should come when?

I also recommend that USAID continue to work closely with other international donors, as it has in the past, to ensure that pension reform technical assistance in Ukraine is well-coordinated, to avoid duplication of assistance and conflicting view points.

I commend USAID/Kiev on the stellar job that it has done to date in the area of pension reform. It had the foresight early on to see the need in this area and responded accordingly. USAID's pension reform technical assistance has made a significant contribution to the GOU's pension reform process, notwithstanding the slow speed of Ukraine's progress. Pension reform in most countries is a slow, difficult and often contentious process. In the end, it has always been worth the struggle when the results lead to an adequate income for several generations of retirees from a fiscally sound and financially sustainable pension system.

Further, USAID/Kiev has designed a pension reform technical assistance approach that works to help USAID/ENI achieve its strategic objectives in several areas: SO 1.2 Increased soundness of fiscal policies and fiscal management practices (ties to providing better public administration and budget management); SO 1.4 A more competitive and market-responsive private financial sector (ties to 2nd and 3rd pillar pension schemes); and SO 3.2 improved sustainability of social benefits and services (ties to providing an adequate pension income to retired workers). I would urge USAID/Kiev to maintain and even expand its pension reform program in keeping with these same goals and objectives.

Summary

In summary, USAID should provide pension reform technical assistance to the GOU in the form of educational and capacity-building assistance. Such assistance should provide the tools that will help Ukraine succeed in accepting, managing and regulating sound public and private pension funds. This assistance should lay the groundwork needed in Ukraine for the people and the policy makers to ultimately address the basic maladies of the current pension system, namely:

A. Providing an **a**dequate income for retirees now and for several generations;

B. Making the **b**ankrupt pension system fiscally sound and financially sustainable;

C. Adjusting **c**ontributions to a prudent level and ensuring that the contributions are collected, recorded and preserved;

D. Using analytical tools and methodologies to structure a pension system that considers the **d**emographic pressures expected in the next 10, 20, 30 or even 50 years;

E. Working to improve the overall **e**conomic and capital markets situation in Ukraine to enable them to be compatible with introducing a mandatory funded pension scheme, including ensuring that the legal and regulatory framework for a reformed pension system will exist and will function with the highest level of professionalism and integrity; and

F. Developing **f**inancial institutions that the people will trust, use and support.

Ukraine Pension System
1998 Data Sheet (year-end)

Average Wage	$50 per month
Average Pension	$20
Poverty Level	$30
Employer Pension Contribution Rate	32%
Employee Pension Contribution Rate	1% to 2% (depending on income)
Number of Retirees	14.5 million
Number of Pension Contributors	16 million
Dependency Ratio	1:1 (roughly)
Number of Employed	22 million
Delinquent Contributions	$1 billion
Delinquent Benefit Payments	$576 million
Replacement Ratio	35%
Retirement Age	60 Men 55 Women
Tax Treatment of Contributions	Full Deduction
Tax Treatment of Benefits	Not Taxed